Review of Co-Investment Strategy

At the November 13, 2001 Investment Committee Meeting, the Committee approved expansion of the Corporate Governance program to include up to $500 million in an Internal Relational Program where staff would make internal co-investments along side Relational Investors' external portfolio.

At the November 14, 2005 meeting of the Investment Committee staff was directed to conduct a comprehensive review of the Internal Relational Program (the "Program"). Staff presented a comprehensive review of the Program to the Investment Committee at its March 13, 2006 meeting. At that meeting, staff was directed to present the comprehensive review of the Program to the Investment Committee after the appointment of CalPERS' new Chief Investment Officer. This Agenda Item is being presented in accordance with that specific direction from the Investment Committee. The Program involves CalPERS partnering with external corporate governance investment managers whereby staff and the manager work together to use additional capital and experience to capitalize on opportunities for excess returns. Since inception, the Portfolio has consisted of investments resulting from CalPERS' partnership with Relational Investors, LLC and Knight Vinke Asset Management. The partnership with Relational Investors, LLC and Knight Vinke Asset Management has resulted in four co-investments in the Portfolio. Staff proposes the program be renamed the co-investment program to reflect the addition of managers beyond Relational Investors LLC.

Strong Performance of the Existing Co-Investment Program

Table 1 shows the positive performance for the Portfolio since inception. It should be noted that this performance was generated primarily by one security. Staff believes the experience it has accumulated in partnership with Relational Investors, LLC and Knight Vinke Asset Management and the positive performance comparison warrant the expansion of the parameters for the total Program with the expectation of making a greater contribution to maximizing the value of the Program to the Total Fund.

Table 1

Performance of the Co-Investment Program

	1 Year	2 Year	3 Year	Since Inception*
Internal Relational Portfolio	21.74%	26.08%	35.06%	30.77%
Benchmark	14.30%	10.44%	18.91%	15.40%
Value Added	7.44%	15.64%	16.15%	15.37%

Information Ratio	0.21	0.47	0.57	0.55

SSB methodology is CFA Institute compliant.
All figures are net of all fees for periods ending March 31, 2006
Inception Date: November 2002.
*Note that from inception to August 3, 2005, the portfolio held only one security.

Review of Co-Investment Strategy

Current policy limits investments in the Program to U.S. publicly traded securities and select European publicly traded securities. Staff seeks input from the Committee on the concept of amending policies that govern the Program to permit global co-investments along side existing successful corporate governance partners to reflect an increase in the number of corporate governance investment managers and a greater geographical diversification of the Corporate Governance Program.

Table 2 shows current corporate governance investment managers and the resulting global diversification of the Corporate Governance Program.

Table 2

Investment Manager	Committed Capital ($mm)	Geographic Mandate
Relational Investors, LLC*	1,400	United States
Shamrock	200	United States
New Mountain Capital	200	United States
Blum Capital	125	United States
Breeden Partners	400	United States
Hermes Asset Management	100 200	Europe United Kingdom
Governance for Owners	200	Europe
Knight Vinke Asset Management**	600	Europe
SPARX	400	Japan
Taiyo Pacific Partners	300	Japan
Total	4,125	

*Includes $397.8 million in 3 co-investments
**Includes $300 million approved for co-investment

Table 3 demonstrates the good performance of the external corporate governance managers.

Table 3

Performance of the External Corporate Governance Program

	1 Year	2 Years	3 Years	5 Years	Since Inception
Corporate Governance Managers	25.77%	22.78%	37.08%	17.64%	17.66%
Benchmark	26.00%	17.81%	28.13%	9.83%	6.58%
Value Added	-0.23%	4.97%	8.95%	7.81%	11.08%
Information Ratio	0.66	0.52	0.66	0.28	0.32

SSB methodology is CFA Institute compliant.
All figures are net of all fees for periods ending March 31, 2006.
Inception Date: January 1999

Proposed Expansion of the Co-Investment Program

Staff proposes the addition of four CalPERS external corporate governance investment managers for the co-investment strategy. The managers being proposed are:

- Shamrock
- Hermes European Focus Fund
- Taiyo Pacific Partners
- SPARX

The criteria for selecting additional corporate governance investment managers as co-investment partners are:

- The investment manager has at least one year experience as a CalPERS external corporate governance manager.
- Since inception, the investment manager's total return is above their specific performance benchmark net of fees.

Proposed co-investment recommendations from external corporate governance investment managers that do not meet the criteria noted above will be brought to the Investment Committee for a decision on a case by case basis.

Table 4 shows the inception date and performance since inception for the four managers being proposed as co-investment partners for the co-investment strategy.

Table 4

Proposed Co-Investment Partner Qualifications
As of March 31, 2006

	Inception Date	Total Return Since Inception (Annualized)	Benchmark Total Return Since Inception (Annualized)	Value Added	Information Ratio
Shamrock	02-01-05	31.42%	20.51%	10.91%	0.20
Hermes European Focus Fund	10-01-03	24.36%	27.98%	6.38%	0.36
Taiyo Pacific Partners	08-01-03	37.78%	26.56%	11.22%	0.62
SPARX	03-01-03	39.68%	28.43%	11.25%	0.51

Additional Staff

To provide sufficient resources in support of the co-investment strategy, staff intends to add a Portfolio Manager to the Corporate Governance staff to successfully manage the co-investment strategy. The successful candidate is expected to have 5-10 years of investment management experience, possess a Masters in Business Administration or equivalent and preferably have the Chartered Financial Analyst designation. The Portfolio Manager in addition to the Senior Portfolio Manager-Corporate Governance and the Senior Investment Officer-Global Equity will comprise the Co-Investment Internal Staff Investment Committee. This Committee will be responsible for strict adherence to the described investment process and provide oversight of the co-investment strategy.

Investment Process

Staff has developed a successful investment process to govern the way co-investments are made in the Portfolio. Companies that are candidates for co-investment will have the following characteristics:

- Considered one of the best ideas in the manager's portfolio
- An underperforming security and company
- Stock price is selling below the embedded intrinsic value
- Manager has a strategy in place to unlock the intrinsic value
- Holding additional shares in CalPERS' Co-Investment portfolio will help the corporate governance managers effect the desired operational and governance changes.

Upon receipt of a co-investment proposal from an external corporate governance investment manager, staff will conduct independent research and analysis to be used in the evaluation of each proposed co-investment. Staff will consistently conduct due diligence using the following steps:

1. Conduct a complete review of all documentation provided by the external corporate governance manager acting as the source for the co-investment idea. The purpose of this step is to understand the investment case being made by the manager, gain knowledge about the strategy for unlocking value embedded in the company as well as assess the potential risk and reward associated with the proposed co-investment.

2. Assess the incremental benefit to the manager's strategy of CalPERS taking a co-investment position. The co-investment strategy must have merits beyond giving the manager capital in their original strategy.

3. Apply the CalPERS Focus List screening criteria to analyze the company under consideration. This process will allow staff to incorporate an additional perspective for evaluating the opportunities to improve the company's corporate governance practices, operation and financial performance and assess potential improvements in these factors.

4. CalPERS Risk Management system will be used to assist in identifying the impact the proposed co-investment will have on the risk characteristics for the Co-Investment Portfolio and the Total Fund.

5. The Senior Investment Officer for Global Equity will have the delegated authority to make all buy and sell decisions for the co-investment strategy. This decision making process will be supported by the recommendation from the external investment manager, research provided to staff by the external investment manager, staff's independent research, industry analysis, the Focus List Program screening process and input from the CalPERS Risk Management System.

Document Retention

All documentation for a proposed and actual co-investment will be maintained in the Corporate Governance Office for three years. After three years all documentation will be moved to an offsite location. Documents retained will include and not be limited to (1) research received from the external manager proposing the co-investment, (2) industry analysis report, (3) company report consistent with the Focus List process, (4) research reports received from a third party, (5) reports from the CalPERS Risk Management System, and (6) letter agreement executed by the CalPERS Legal office.

Letter Agreements

A Letter Agreement for each co-investment will be executed between the external corporate governance manager and the CalPERS Legal office before trading in the stock of the proposed co-investment can begin. The Letter Agreement notes the specific terms and conditions for the co-investment relationship between CalPERS and the external corporate governance investment manager. Specifically, the Letter Agreement will identify the proposed co-investment company, applicable performance objective and benchmark, method for calculating incentive fees to be paid to the investment manager if performance objectives are met. Fees associated with co-investments will generally not include the base management fee and may have a lower incentive fee reflecting the fact that there are no incremental costs to the manager as a result of CalPERS buying additional shares.

Trading

Upon execution of a Letter Agreement, staff will coordinate trading with the external manager and execute trading in the shares of the co-investment target through the CalPERS Global Equity Trading Desk ("Desk"). Staff will notify the Desk of the co-investment target and the external manager tied to the specific co-investment to be traded. The Desk will communicate with the external manager to gain market intelligence that will contribute to achieving "best execution" for both purchases and sales of the shares of the co-investment target. For co-investment in non-US equity securities, a non-US dollar currency may be required to execute the trade. In conjunction with the Desk, staff will coordinate with the currency management staff.

Staff will use a template to provide consistent and accurate information about the co-investment target to the Desk. The template will specify the name of the co-investment target, the quantity of shares to be traded, the type of transaction to be executed, the type of order being submitted for execution (i.e. market order, limit order, etc.), and the specific currency denomination required for the trade. Additional trading instructions (verbal or written) may be given to the Desk by the Portfolio Management staff. Information contained in the trading template will also be used by the Desk for compliance checks and to facilitate the settlement of trades. The Desk will apply all of its record management requirements to documentation pertaining to trading in co-investments.

Compliance

Staff has worked with CalPERS' Legal office and Wilshire Associates to identify areas of potential risk and to implement procedures to mitigate against such risk. Specifically, CalPERS Global Equity and Legal staff, external legal counsel to CalPERS and Wilshire Associates staff have reviewed CalPERS' exposure to the risk of insider trading and information. CalPERS Legal staff supports the adequacy of the existing rules and additional procedures outlined below to minimize this risk. Additional rules and procedures that are being incorporated into the Program include:

- New Letter Agreements will state that the co-investment partner will not share with CalPERS staff any non-public information from the co-investment partner.
- Existing Letter Agreements with current co-investment partners will be amended to state that the co-investment partner will not share with CalPERS staff any non-public information.
- In coordination with the legal office, CalPERS policies and procedures will be amended to include steps staff is required to take in the event staff were to receive non-public information.
- Staff will formalize the incorporation of a disclosure statement into its company engagement procedures to state that CalPERS seeks no non-public information.

In addition, staff has been working with CalPERS Legal office to develop and execute procedures governing an "Ethical Wall" between CalPERS' Focus List Program and CalPERS employees outside the Corporate Governance Office. Staff will utilize the same procedures to govern the "Ethical Wall" between the Portfolio and CalPERS employees outside the Corporate Governance Office.

Regulatory Reporting Requirements

Due to the nature of the Program, investments will involve taking substantial incremental positions that will impact CalPERS' holdings as a percentage of the company's total shares outstanding. At times, these investments may fall under the group rule for purposes of Securities and Exchange Commission (SEC) Regulation 13(d) and will have filing requirements under this Regulation. In the unusual circumstances where filing requirements are potentially harmful to the strategy being employed to unlock the intrinsic value embedded in a company, staff in coordination with the legal office may deem it financially more advantageous to temporarily relinquish CalPERS' proxy voting rights in a co-investment.

Staff has consulted with CalPERS legal staff on this matter. An alternative to relinquishing CalPERS' proxy voting rights from time to time on specific securities is to closely monitor the size of our portfolio holdings to be sure that we stay well below the threshold that triggers SEC filing requirements and deliberately limit the size of CalPERS co-investment positions.

Reporting to the Investment Committee

Wilshire Associates will include the Program in its quarterly performance report to the Investment Committee. Each co-investment will be maintained and accounted for in a separate account tied to the external manager providing the co-investment recommendations. (For example all co-investments entered into with SPARX will be captured in a separate co-investment account maintained at State Street Bank). The performance benchmark for the investment manager providing the co-investment will be the same as its respective Portfolio. This methodology will provide full disclosure and transparency to the Investment Committee on performance pertaining to each co-investment partner and their respective Portfolio. The performance for the entire Program will be the dollar-weighted average of the total return for each Portfolio associated with a specific external investment manager.

Annual and Quarterly Reports to the Investment Committee

In addition to reports provided on the Program to the Investment Committee by Wilshire Associates, staff will provide the Investment Committee with an annual review in the form of an annual agenda item similar to what the Committee receives regarding the MDP Program. Staff will also provide the Investment Committee with a Quarterly Review Executive Summary, similar to the Risk Managed Absolute Return Strategies Program report received by the Committee.

Allocation of Capital

Staff is considering $150 million to be the maximum allocation of capital for co-investment in partnership with an external corporate governance manager. A maximum of 3 co-investments made with each co-investment partner is also under consideration by staff. Based on the addition of 4 co-investment partners, the co-investment strategy would have $600 million in additional committed capital.

The current capital allocation for the CalPERS Corporate Governance Program is equal to 3% of total market value of Global Equity assets plus or minus 2%. As of March 31, 2006, the market value of total Global Equity assets was $134 billion. Based on the market value of $134 billion, the maximum allocation for the CalPERS Corporate Governance Program is approximately $6.5 billion. The market value for the CalPERS Corporate Governance Program after an expansion of the parameters for the Co-Investment Program (proposed herein) would be approximately $5 billion, within the allowable range for capital allocated to the Corporate Governance Program.

Delegations

Current Policy would be amended to delegate authority to the Senior Investment Officer-Global Equity to approve each buy and sell co-investment decision. Staff is considering an additional $600 million in committed capital to the Corporate Governance co-investment strategy. The $600 million limit for additional committed capital is expressed in dollar terms and not in percentage terms due to fact that this is a relatively new initiative. However, the current capital allocation for the CalPERS Corporate Governance Program is reflected in percentage terms and is 3% of Global Equity assets, plus or minus 2%. As a result, this is consistent with Investment Committee substantive considerations for granting delegations.

Risk Management Viewpoint (prepared by the Risk Management/Asset Allocation unit)

Objective: To estimate the effect of increasing CalPERS allocation to the corporate governance active investment strategy on the risk to CalPERS portfolio.

Summary Conclusion: A larger investment in corporate governance funds would have essentially no effect on the forecasted total risk, though would result in higher forecasted active risk, or the potential for a greater disparity of returns between the actual plan and the policy benchmark.

Methodology: The proposed program increases the funding allocation of ten existing corporate governance investment managers. The strategic targets for corporate governance active investment strategy are increased from the current total approximate market value of $4.4 billion to a potential target totaling $5.0 billion. We were able to obtain and model the majority of the holdings in these accounts. The test involved assuming the same holdings and risk profiles of the individual accounts, and increasing their funding as proposed by the agenda item. In order to isolate the risk impact of this investment strategy, as opposed to affecting any changes in risk due to shifts in asset allocation, we assumed the new portfolio would be funded by a proportionate reduction in the domestic equity and international equity passive accounts. The changes in portfolio funding were configured within the context of the actual CalPERS holdings as of December 31, 2005 and run through the Barra TotalRisk model and CalPERS Risk Measurement System.

Results: The values presented in the table below represent the forecasted annual standard deviation of returns (%) over the next twelve months. Because of the size of the CalPERS total fund, and the diversification of investments within the total fund and within the global equity portfolio, shifting funds to this investment strategy is estimated to have minimal impact to the Fund total risk profile. The total risk of the total plan is generally determined by asset class weightings, which are assumed to not change with the adoption of this proposal. There is the potential for increased active risk, or greater difference in expected returns compared to the policy benchmark, because funds are shifted from the passive benchmark allocation to the corporate governance managers. As shown below, the active risk for global equity is forecasted to increase by approximately 50 basis points or 8%, and approximately 20 basis points or 3% for the total fund.

The corporate governance portfolios tend to be highly concentrated, holding large positions in a few securities, compared to most of CalPERS equity portfolios. This increased allocation to individual securities increases the specific risk component of active risk. Specific risk is the risk that is unique to each security as opposed to common factor risks of securities, such as industry, currency or company size. Based on the assumed increased investments in the portfolio’s current holdings, active risk is also increased due to greater exposures to Japanese and European securities. The model shows greater active risk due to increases in both the equity risk from these countries and the corresponding currency risk.

Risk Analysis

TOTAL RISK	Current Plan	$600 MM Corp Gov Add
Global Equity	11.5%	11.5%
Total Plan	8.46%	8.46%
ACTIVE RISK		
Global Equity	0.647%	0.696%
Total Fund	0.659%	0.674%

Assessment of Program Risks and Opportunities (Provided by Global Equity Staff)

Risks

- Reputational Risks: CalPERS’ name in the corporate governance arena is important, has value, and must be used with great care.

- Volatility: The corporate governance managers and the co-investment portfolios will be highly concentrated portfolios that are more volatile and require a longer time horizon over which to judge performance.

- Concentrated portfolios: There is a higher degree of security-specific risk associated with portfolios with only a small number of positions. This risk is mitigated by the large size of the Total Fund and Global Equity overall.

- Performance: This strategy could be subject to underperformance.

- Exposure: The Investment Committee is directly exposed whenever Staff makes an investment decision, but all the documentation, process and the fact that the investments can be sold in the event of a mistake are all mitigating factors.

Opportunities

- Performance: Global Equity can improve its long-term performance by allocating more capital to higher alpha generating strategies such as corporate governance co-investments. Performance of the external corporate governance managers over longer time horizons is outstanding. Corporate governance managers are among the best performers in the Global Equity asset class.

- Effective Strategy: Engaging underperforming companies with activist managers has proven to be an effective strategy for CalPERS over the last 10 years. Taking co-investment positions enhances the contribution to Global Equity and Total Fund performance.

- Reputational Rewards: CalPERS further strengthens its leadership position in the governance arena by engaging underperforming companies and improving operating performance and governance practices.

- Capacity: There is scarce capacity in the best investment opportunities. Given CalPERS large size, we should allocate more capital to the best investment managers and opportunities.

- Risk Taking: Given the large size of the Global Equity asset class and the large volume of assets in the index fund, more risk needs to be taken in order for attractive returns to be generated. As opportunities for co-investment arise with proven managers, staff recommends that we utilize this as an opportunity to take more risk. Prudent risk taking is an attractive investment opportunity.

Conclusion and Summary

Subject to feedback and direction from the Investment Committee, staff would return to the Investment Committee with a recommendation to:

1) Allow the addition of 4 co-investment managers to the Co-Investment Program. Each co-investment manager will have at least one year experience as a CalPERS corporate governance investment manager and will have added value versus their specific performance benchmark since inception.

2) Provide for each additional co-investment partner to have up to three co-investment securities and $150 million in committed capital, subject to agreement and coordination with Global Equity and Corporate Governance Staff.

3) Allow for the addition of a Portfolio Manager to the Corporate Governance staff, responsible for successfully managing the co-investment strategy.

4) Report annually to the Committee on the performance of this strategy and have the Board's General Pension Consultant report on performance quarterly. In addition, staff would provide a transaction summary quarterly to the Investment Committee.

5) Provide appropriate trading and investment process procedures including buy and sell disciplines.

6) Provide for appropriate document retention.

7) Provide for appropriate compliance procedures to guard against insider trading.

8) Provide for appropriate regulatory filing procedures, including from time-to-time relinquishing CalPERS' proxy voting rights to external corporate governance managers in certain situations approved by the CalPERS Legal Office.

9) Appropriately amend the Co-Investment policies at the Investment Policy Sub-Committee.